

LIBRARY
SUPREME COURT, U. S.

Office Supreme Court, U.S.

FILED

NOV 24 1964

JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

No. 628.

OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,

Petitioner,

vs.

MIDLAND-ROSS CORPORATION,

Respondent.

**ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT.**

BRIEF FOR RESPONDENT IN OPPOSITION.

THEODORE R. COLBORN,
1750 Union Commerce Bldg.,
Cleveland 14, Ohio,
Counsel for Respondent.

THEODORE M. GARVER,
JONES, DAY, COCKLEY & REAVIE,
1750 Union Commerce Building,
Cleveland 14, Ohio,
Of Counsel.

TABLE OF CONTENTS.

Opinions Below	1
Jurisdiction	1
Question Presented	2
Statement	2
Argument	3
A. The Issue Is Not of Continuing Importance ..	3
B. The Decision Below Is Correct	7
1. The Government's disarmingly simple formulation significantly distorts the real nature of the problem involved	7
2. The most directly relevant authorities have not been considered by other Courts	10
Conclusion	17
Appendix:	
Memorandum of the District Court on Tax Treat- ment of Original Issue Discount	18

TABLE OF AUTHORITIES.

Cases.

<i>Baltimore & Ohio R. R. Co. v. Commissioner</i> , 78 F. 2d 460 (4th Cir. 1935)	8
<i>Commissioner v. Caulkins</i> , 144 F. 2d 482 (6th Cir. 1944)	11, 14, 15, 16
<i>Commissioner v. Korell</i> , 339 U. S. 619	10
<i>Commissioner v. Morgan</i> , 272 F. 2d 936 (9th Cir. 1959)	10
<i>Corn Exchange Bank v. Commissioner</i> , 6 B. T. A. 159 (1927)	14
<i>Deputy v. DuPont</i> , 308 U. S. 488	7
<i>Fisher v. Commissioner</i> , 209 Fed. 2d 513 (6th Cir., 1954) cert. denied 347 U. S. 1014	15-16
<i>Hanover Bank v. Commissioner</i> , 369 U. S. 672	10
<i>Harrison v. United States</i> , 304 Fed. 2d 835 (5th Cir. 1962), cert. denied 372 U. S. 934 (No. 681, 1962* Term)	3, 10, 11

<i>Helvering v. Union Pacific Co.</i> , 293 U. S. 282 -----	15
<i>Josey v. Commissioner</i> , 104 F. 2d 453 (10th Cir. 1939) -----	8
<i>Kingsford Co. v. Commissioner</i> , 41 T. C. No. 64 (1964) -----	8
<i>Lubin & Eisner v. Commissioner</i> , not yet reported, 64-2 USTC par. 9666 (2nd Cir. 1964) -----	11
<i>May v. Commissioner</i> , T. C. Docket No. 67,659 -----	6
<i>Meyer v. Commissioner</i> , T. C. Docket No. 1198-63 --	6
<i>New York Life Ins. Co. v. Edwards</i> , 271 U. S. 109 --	9
<i>Old Colony R. R. v. Commissioner</i> , 284 U. S. 552 --	9
<i>Paine v. Commissioner</i> , 236 F. 2d 398 (8th Cir. 1956) -----	8
<i>Pattiz v. United States</i> , 311 F. 2d 947 (Ct. Cl. 1963) -----	11
<i>Real Estate Investment Trust of America v. United States</i> , No. 620, 1964 Term -----	11
<i>Rosen v. United States</i> , 288 F. 2d 658 (3rd Cir. 1961) -----	10
<i>Sherwood Memorial Gardens, Inc.</i> , 42 T. C. 211 (1964) -----	6
<i>United States v. Dixon</i> , No. 486, October term, 1964 ----- 3, 11, 12, 17	
<i>United States v. Harrison</i> , 304 F. 2d 835 (5th Cir. 1962) -----	11
<i>United States v. Snow</i> , 223 Fed. 2d 103 (9th Cir., 1955) cert. denied 350 U. S. 831 -----	15
<i>Western Maryland Ry. Co. v. Commissioner</i> , 33 F. 2d 695 (4th Cir. 1929) -----	14

Statutes.

Internal Revenue Code of 1939:

Sec. 42(b) -----	13
Sec. 42(c) -----	13
Sec. 113(b) (1) (H) -----	13
Sec. 117(a) (1) (D) -----	13
Sec. 125 -----	9, 13
Sec. 201(e) -----	13
Sec. 207(d) -----	13
Sec. 211(a) (1) (B) -----	14

Internal Revenue Code of 1954:

Sec. 1232 -----	4, 5, 6, 12
Sec. 1232(a) (2) -----	2, 6
Sec. 1232(b) (1) -----	4

Revenue Act of 1964, Sec. 224	8
31 U. S. C. § 754(b)	11
31 U. S. C. § 757c(d)	11

Miscellaneous.

<i>Accountants' Handbook</i> 339 (2d ed. 1939)	15
Acq. 1944 Cum. Bull. 5, non-acq. 1055-1 Cum. Bull. 7	14
71 Cong. Rec. 2319-2333 (June 4, 1929)	12, 13
5 CCH 1952, Stand. Fed. Tax Rep. pars. 6161, 6284	14
I. T. 1398, I-2 Cum. Bull. 149 (1922)	14
I. T. 3513, 1941-2 Cum. Bull. 75	8
1 T. C. 656, 662 (1943)	15
Janin, <i>The Israeli Bond Ruling: Legislation by Administrative Fiat</i> , 33 Taxes 191 (1955)	7
Lawrence, <i>Bond Discount Treatment Under the 1942 Revenue Act</i> , 21 Taxes 651 (1943)	15
2 Mertens <i>Law of Federal Income Taxation</i> , §§ 12.109, 12.118, 12.121-12.126, 12.47, 12.95	6, 14
4 Mertens <i>Law of Federal Income Taxation</i> , §§ 23.162, 23.167	10, 15
Molloy, <i>The Ambiguous Tax Nature of the Various Costs of Borrowing Capital</i> , 11 Tax Law Review 373, 399-400 (1956)	14
Newlove, <i>Intermediate Accounting</i> 205 (1939 ed.)	15
O. 1024, 2 Cum. Bull. 189 (1920)	14
O. D. 475, 2 Cum. Bull. 211 (1920)	14
Paton, <i>Advanced Accounting</i> 196 (1941)	15
<i>Report of Subcommittee of Committee on Ways and Means</i> , dated January 1, 1938, reported in <i>Hearings on H. R. 9682</i> , 75th Cong. 3rd Sess. p. 38	13
Rev. Rul. 119, 1953-2 Cum. Bull. 95	7, 14
Standard & Poor's <i>Earnings and Ratings, Bond Guide</i> (Standard & Poor's Corp., Oct. 1964)	4
3 U. S. Code Congressional and Administrative News 1954, p. 4110	12

In the Supreme Court of the United States

No. 628.

OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,

Petitioner,

vs.

MIDLAND-ROSS CORPORATION,

Respondent.

**ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT.**

BRIEF FOR RESPONDENT IN OPPOSITION.

OPINIONS BELOW.

The opinion of the United States District Court for the Northern District of Ohio (R. 20a-36a),¹ is reported at 214 F. Supp. 631 and is reproduced in the Appendix to this Response. The opinion of the Court of Appeals is reported at 335 F. 2d 561.

JURISDICTION.

The jurisdictional requisites are adequately set forth in the Petition for Writ of Certiorari.

¹ R. refers to the Appendix to the Government's brief in the Court of Appeals.

QUESTION PRESENTED.

Is there sufficient continuing importance in the matter to justify this Court's intervening to review decisions on whether, under the law as it existed prior to 1954, the increase in value of a debt obligation issued at less than face value should be taxed as if it were interest?

STATEMENT.

Respondent is the successor by merger to Industrial Rayon Corporation (Industrial) (Stip. par. 2, R. p. 14a). During 1952, 1953 and 1954 Industrial, following a long practice (Stip. par. 26, R. p. 19a), used its excess funds to acquire various non-interest bearing corporate notes of the type commonly used for financing by General Motors Acceptance Corporation, Commercial Investment Trust Co. and Commercial Credit Co. at less than their face value (i.e., at a discount) (Stip. par. 11-20, R. pp. 15a-18a). Each of the notes were sold prior to maturity at a profit which aggregated \$282,763 (Stip. par. 11-20, R. pp. 15a-18a). Industrial reported this profit as capital gain, partly long-term and partly short-term (Stip. par. 27, R. p. 20a). The Internal Revenue Service asserted a deficiency on the ground that the profit should be taxed as if it were interest. Industrial paid the applicable tax and instituted this action for its refund.

There is no contention that the discount at which the notes were purchased was, as a factual matter, interest in disguise. On the contrary, it is stipulated that there was no interest (Stip. par. 11-20, R. pp. 15a-18a) and that Industrial realized gains from the sale of capital assets (Stip. par. 23, R. p. 19a).

Under the law which has been in effect since December 31, 1954, the profit would be taxed as ordinary income.²

² Section 1232 (a) (2), Internal Revenue Code of 1954.

However, the transactions involved here occurred prior to the change in the law, so that respondent contends, and the lower court held, that the profit should be taxed as capital gain.

ARGUMENT.

A. THE ISSUE IS NOT OF CONTINUING IMPORTANCE.

The Government contends that even though the law involved here was changed ten years ago, the question presented is still important (Government's Br. p. 8).³ This is in direct conflict with the Government's position only one year ago in its brief in opposition to a petition for certiorari in *Harrison v. United States*, 304 Fed. 2d 835 (5th Cir. 1962), cert. denied 372 U. S. 934:

"Moreover, the question here in dispute is of rapidly diminishing importance, for Section 1232(a)(2) of the 1954 Code (*supra*, pp. 3-4) expressly provides that as to bonds issued after December 31, 1954 any gain realized by a bond holder attributable to original issue discount is taxable as ordinary income. Compare *Valley Morris Plan v. Commissioner*, No. 447 October Term 1962, certiorari denied, 371 U. S. 922." (Brief in Op., No. 681, 1962 Term pp. 7-8.)

Nevertheless, the Government now argues that there are three separate reasons for the continuing importance of the identical question.

First, although it admits that the pending cases on this issue are relatively few in number, the Government says it has "no solid basis" to dispute the claim made by petitioners in *Dixon v. United States* "that there may be some such obligations [issued prior to 1955] still outstanding".

³ All references to the Government's Brief are to the brief filed in *Dixon v. United States*, No. 486, 1964 Term, which the Government treats throughout as applicable to the present case as well.

(Government's Br. p. 8) and that there are open transactions. For this Court to grant certiorari merely on the basis of the Government's assertion that it has no solid evidence that the issue is not important would be extraordinary. Furthermore, examination of readily available material clearly indicates that any remaining problems in this area cannot be substantial.

Since the type of obligation involved here and in *Dixon v. United States, supra*, is not issued with more than a twelve month maturity, all issued before 1955 were retired nine years ago. Under the circumstances, it is highly unlikely that there are open controversies concerning them.

As to types of obligations not directly involved, an examination of Standard & Poor's recent bond guide⁴ covering approximately 3,000 outstanding bond issues reveals that there are now only two issues of domestic bonds⁵ reported which were originally issued at a discount sufficient to be taxed under Section 1232,⁶ neither of which would necessarily be governed by a decision here.⁷

⁴ Standard & Poor's *Earnings and Ratings Bond Guide* (Standard & Poor's Corp., Oct. 1964).

⁵ In addition the Guide lists eight such foreign issues, all now in default, as to which only questions clearly different in nature from that presented here could arise since the discount in all probability was attributable in large measure to the uncertainties of deferred payment in foreign currency. There are further listed two foreign perpetual bonds issued at discounts as to which no annual discount rate can be computed and which would therefore also involve a different point.

⁶ The statute only affects discounts in excess of $\frac{1}{4}$ of 1% per year. Section 1232(b) (1) Internal Revenue Code of 1954.

⁷ One of these bonds has traded as high as 99 $\frac{1}{2}$ (Cincinnati, Indianapolis and Western R.R. 5% First Mortgage Bonds issued in 1922 due 1965) raising the question of the amount to be taxed to an intermediate purchaser who bought at such a price. The other issue (The Cleveland, Chicago and St. Louis R.R., Cincinnati)

The outstanding bonds of these two issues were originally sold in 1916 and 1922 at discounts aggregating one and one-half million dollars, but of this only about \$250,000 remains to be realized.⁸ While there may be other bonds not listed in the Standard & Poor's Guide which would still be affected by the old law, the very small percentage of such bonds in the Guide indicates that any remaining problem is not substantial.

Second, while Section 1232 does not apply to obligations issued by individuals, there is no reported case involving such an individual obligation. If such a case should ever arise, that will be time enough to decide whether it merits the attention of this Court.

Third, the Government argues that Section 1232 does not answer whether discount must be accrued from day to day as if it were interest, or if it should be taxed in the year of the sale or redemption of the obligation involved (Government's Br. pp. 9-10). This asserted problem can, at most, affect the year in which the income is taxed, not the amount of income. Further, the statute explicitly requires that the gain "be considered as gain from the

(Continued from preceding page)

nati, Wabash and Michigan Division 4% First Mortgage Bonds of 1916 due 1990) have not traded as high as their issue price for many years and therefore involve the different question of the realization of discount income where there is no increase in value with the passage of time. Furthermore, similar problems, not presented in the cases before the court, undoubtedly exist with respect to discount bonds possibly not listed in Standard & Poor's, so that the number of situations which would be affected by a decision here is most likely only a small fraction of whatever pre-1955 bonds may be outstanding.

⁸ The amount of discount subject to possible controversy undoubtedly lies between these two figures. As to purchasers of the original issue, the full discount could be involved. As to intermediate purchasers, varying amounts may be involved, depending on the time of purchase and the price.

sale or exchange of property which is not a capital asset.”⁹ Detailed rules have been developed for the reporting of such gain¹⁰ which in many respects differ from the rules for reporting interest.¹¹ Assuming *arguendo* that a decision here would affect the interpretation of Section 1232, a characterization of discount as “interest” would simply create confusion as to which set of detailed rules should govern under present law.

All indications are that the question involved here is simply one of historical interest. There are even fewer cases than the Government indicates, since some of those listed involve patently different issues;¹² the amounts involved are not great and the questions remaining under Section 1232 are insignificant. At most, the Government simply speculates that problems remain.

⁹ Section 1232(a) (2) (A) Internal Revenue Code of 1954.

¹⁰ These rules are set forth at length in 2 Mertens *Law of Federal Income Taxation*, §§ 12.118 & 12.121-12.126, Esp. §§ 12.125 & 12.126.

¹¹ See 2 Mertens *Law of Federal Income Taxation*, §§ 12.47 & 12.95.

¹² Of the three cases so cited (Government's Br. 8-9, n. 6) counsel for the taxpayers report that *Meyer v. Commissioner*, T. C. Docket No. 1198-63 involves post-1955 documents, some of which have already been held in *Sherwood Memorial Gardens, Inc.*, 42 T. C. 211 (1964) to be stock rather than debt; which have no principal amount, and which entitle the holder simply to a share of the proceeds of sale of cemetery lots; *May v. Commissioner*, T. C. Docket No. 67,659 involves principally the question whether a genuine indebtedness existed although approximately 2½% of the alleged deficiency involves an issue similar to that presented here.

B. THE DECISION BELOW IS CORRECT.

1. The Government's disarmingly simple formulation significantly distorts the real nature of the problem involved.

The Government reduces the merits of this case to a comparison between a \$100 note bearing 6% interest and a \$106 non-interest bearing note issued for \$100 (Government's Br. p. 4), citing *Deputy v. DuPont* for the proposition that "Interest is 'merely compensation for the use of forbearance of money.'" ¹³ (Government's Br. p. 5.) This deceptively simple illustration ignores the real nature of the problem involved. There is no doubt that interest (which is "compensation for the use of money") is taxed as ordinary income. It is equally true, however, that courts have long recognized that certain types of "compensation for the use of money" result in capital gain. The problem is where under the old law the line should be drawn to distinguish among variations in commercial practice. All had agreed, prior to 1953,¹⁴ that the line had been drawn so as to treat discount as a capital item.

One common example of compensation for the use of money accorded capital gain treatment arises upon the sale of a capital asset for a deferred purchase price greater than the price that would be charged in a cash sale. Here there is plainly a gain to the seller due entirely to the use of the seller's money by the purchaser. Yet it is clear that prior to the 1964 Revenue Act the entire purchase price

¹³ In the *DuPont* case itself, the phrase had been used to contrast compensation for use of *common stock*. *Deputy v. DuPont*, 308 U. S. 488, 498.

¹⁴ In 1953 the Revenue Service first publicly reversed its long-standing position that discount was a capital item. Rev. Rul. 119, 1953-2 Cum. Bull. 95. This change in position is analyzed in Janin, *The Israeli Bond Ruling: Legislation by Administrative Fiat?*, 33 *Taxes* 191 (1955).

was taxed as capital gain. See *Paine v. Commissioner*, 236 F. 2d 398 (8th Cir. 1956); *Kingsford Co. v. Commissioner*, 41 T. C. No. 64 (1964). Similarly the increase in the value of a lease during an initial period when rents are not due is treated as capital in nature. *Josey v. Commissioner*, 104 F. 2d 453 (10th Cir. 1939). On the Government's theory that all compensation for the use of money is interest, indeed, Section 224 of the 1964 Revenue Act, which imputes a quantum of interest to certain deferred payment sales which do not on their face bear interest, was a wholly superfluous enactment.¹⁵

Nor is it necessary to refer to prior case law to establish that the equation of discount with interest wholly fails to take into account commonplace commercial realities. Discount, for example, can be attributable primarily to the fact that an obligation is to be repayable in foreign currency¹⁶ yet it would make no economic sense at all to tax all or any part of such a discount as ordinary income. And of course it is conceded that gain attributable to market discount does not result in ordinary income for tax purposes, so that if a bond is issued at 100 and later declines to 90, the 10 point gain on maturity of a purchaser at 90 is accorded capital gain treatment.

Moreover, decisions of this Court dealing with the tax treatment of bond premiums flatly refute the Government's equation of sums paid as "compensation for the use

¹⁵ Other instances in which compensation for the use of money has not resulted in interest income treatment are to be found in the ruling involving discount for prepayment of insurance premiums at a 3% per annum compound rate, I. T. 3513, 1941-2 Cum. Bull. 75, and the decision of the Fourth Circuit in *Baltimore & Ohio R. R. Co. v. Commissioner*, 78 F. 2d 460 (4th Cir. 1935) involving discount at the rate of 6% per annum for prepayment of the purchase price for stock.

¹⁶ The problem of repayment in foreign currency is far from a hypothetical one. See note 5, *supra*.

or forbearance of money" with interest income. Bond premium, of course, is identical in principle to discount. Premium is simply the amount by which the price exceeds face value, while discount is the amount by which the price falls short of face value. This Court first rejected any principle of taxation based on an artificially constructed "effective rate of interest" in *New York Life Ins. Co. v. Edwards*, 271 U. S. 109, when it held that bond premiums could not be amortized in order to allow the taxpayer to be taxed on less than the actual interest it received. And in *Old Colony R. R. v. Commissioner*, 284 U. S. 552, this Court stated the very argument advanced by the Government here:

The conclusion is that the actual return to one who pays a premium is less than the nominal interest carried by the bond, and to one who buys at a discount is greater than such nominal rate. The argument is that although the regulations are inaptly phrased and are susceptible of the construction petitioner places upon them their real intent was to adjust the nominal interest paid on a corporation's indebtedness to the actual amount it is paying for the use of the money represented by the par of the bond,—that is, to what accountants have called the 'effective rate' of interest. 284 U. S. at 558-559.

only to reject it decisively:

We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountants' phrase 'effective rate' of interest and intended that as the measure of the permitted deduction.¹⁷ 284 U. S. at 561.

¹⁷ In 1942 legislation was enacted to permit an offset of bond premium against interest received. Section 125, Internal Revenue Code of 1939. Bond premium may now be amortized in ac-

(Continued on following page)

2. The most directly relevant authorities have not been considered by other Courts.

While the Sixth Circuit reached a result contrary to that arrived at by several other courts, it cannot be over-emphasized that the decision below is the only one which analyzed the real problem involved, and (perhaps as a consequence) is the only one which so much as mentioned *any* of the legal materials which should be determinative.¹⁸ In describing the two earliest opinions that had reached a different result, the District Court, in its opinion which was adopted by the Sixth Circuit, noted:

In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. R. pp. 34a-35a.¹⁹

(Continued from preceding page)

cordance with the statutory election, but unless the election is made it is still considered a capital item. 4 Mertens, *Law of Federal Income Taxation*, §§ 23.162, 23.167.

In *Commissioner v. Korell*, 339 U. S. 619, holding that a premium paid for a conversion privilege was amortizable, this Court rejected the Treasury's argument that the adjustment permitted by Section 125 should be allowed only to the extent that it achieved an "effective interest rate." And in *Hanover Bank v. Commissioner*, 369 U. S. 672, this Court, holding that bond premium amortization could be based on a special call price which probably would not be used, once again definitely rejected the Government's plea that amortization be permitted only on the basis of an "effective rate of interest."

¹⁸ Undoubtedly this was for the most part because these materials were not presented to the courts. Compare e.g., the limited use of materials in the Petition for Certiorari in *Harrison v. United States*, cert. denied, 372 U. S. 934 (No. 681, 1962 Term) with the District Court's decision below.

¹⁹ The reference is to *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir. 1959) and *Rosen v. United States*, 288 F. 2d 658 (3rd Cir. 1961).

The court went on to point out that the other two differing opinions were based largely on an adoption of the two earlier decisions, and again:

neither case considered the historical treatment of original issue discount. R. p. 35a.²⁰

Indeed, even the Sixth Circuit in its earlier decision in *Commissioner v. Caulkins*, 144 F. 2d 482 (6th Cir. 1944), while it reached the correct result, did so without the benefit of this material.²¹

While it is not our purpose to argue the merits of the case on the certiorari proceedings, it is necessary to point out the extent of the materials which do not seem to have been considered by any Circuit other than the Sixth.

²⁰ The reference is to *United States v. Harrison*, 304 F. 2d 835 (5th Cir. 1962) cert. denied 372 U. S. 934 and *Pattiz v. United States*, 311 F. 2d 947 (Ct. Cl. 1963). While the District Court's opinion in the instant case was issued prior to the decisions of the First and Second Circuits in *Real Estate Investment Trust of America v. United States*, No. 620, 1964 Term, and *Dixon v. United States*, *supra*, no Circuit Court at the time of those decisions had considered the material which the Sixth Circuit found controlling and neither the First nor Second Circuits referred to any of this material. The Second Circuit, moreover, in a situation where the commercial circumstances underlying the transaction differed from those presented in *Dixon*, has recently indicated its rejection of the sweeping formulation on which the Government bases its case in this Court, by reaching a result consonant with that arrived at by the Sixth Circuit. *Lubin & Eisner v. Commissioner*, not yet reported, 64-2 USTC par. 9666 (2nd Cir. 1964).

²¹ The Sixth Circuit in the *Caulkins* case was cited to largely irrelevant legislative history concerning the issuance of non-interest bearing Treasury Bonds, the discount on which is by statute equated with interest. The original enactment was in 1929 (presently § 754 (b) of Title 31 U. S. C.) and the legislative history of this enactment shows clearly that Congress understood discount in the absence of such a statute to be a capital item. See nn. 23-24, *infra*. Subsequently, in 1935, a similar provision was enacted (presently § 757c (d) of Title 31 U. S. C.) as to which there is virtually no legislative history. The Sixth Circuit in the *Caulkins* case was referred only to the latter enactment.

First, in contrast to the report of the Senate Finance Committee cited in the *Dixon* case, the House Ways and Means Committee, in connection with the enactment of Section 1232, stated:

(E) Bonds and other debt (sec. 1232).

Under existing law any gain realized from a corporate or Government bond in registered form or with coupons attached is *treated as a capital gain either if the bond is held to retirement or if it is sold or exchanged*. Part or all of the gain, however, may represent discount on original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.

Effective with respect to bonds issued after December 31, 1954, the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. * * * 3 U. S. Code Congressional and Administrative News 1954, p. 4110. (Emphasis added.)

Other major areas of legislative history, which have been considered only by the Court below, include the representation of the Under Secretary of the Treasury to the Senate Finance Committee in 1929 that the increment in commercial paper issued at a discount (apparently of the very type involved here) was capital gain;²² a Senate debate in 1929, indicating that the Senate so understood the law;²³ and a recommendation by a subcommittee of

²² A statement of Senator Couzens indicates that the Under Secretary of the Treasury, Ogden Mills, so reported to the Senate Finance Committee at an executive session. 71 Cong. Rec. 2329 (June 4, 1929).

²³ 71 Cong. Rec. 2319-2333 (June 4, 1929) where Senator Reed said:

Mr. President, it seems to me that these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument [a discount

(Continued on following page)

the Ways & Means Committee of the House of Representatives that there be no change in the law which taxed the increment arising from purchase at a discount as capital gain.²⁴ Congress, moreover, was active throughout the pre-1954 period at issue here, and the numerous legislative enactments governing the tax treatment of both bond discount and bond premium²⁵ are wholly inconsistent with a Congressional purpose to change *sub silentio* the treatment of bond discount as a capital item; a treatment which Congress must have assumed in enacting these specifically defined legislative exceptions to the recognized general rule. When Congress did act on the precise question here at issue, in 1954, it acted explicitly and, more significantly, its enactment was explicitly prospective.

In addition to this legislative history, thoroughly analyzed in the District Court's opinion reproduced in the

(Continued from preceding page)

obligation] is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, is a *capital gain* which is the equivalent of interest on the money. (Emphasis added.) 71 Cong. Rec. 2331 (June 4, 1929).

²⁴ Report of Subcommittee of Committee on Ways and Means, dated January 1, 1938, reported in *Hearings on H. R. 9682*, 75th Cong. 3rd Sess. p. 38.

²⁵ Section 117(a) (1) (D), Internal Revenue Code of 1939, excluding from the definition of capital assets short term discount obligations without interest issued by governmental units; Section 201 (e), Internal Revenue Code of 1939, requiring amortization of both discount and premium on all obligations but only for life insurance companies; Section 207(d), Internal Revenue Code of 1939, requiring amortization of discount and premium on all obligations but only for mutual insurance companies; Section 42(b), Internal Revenue Code of 1939, allowing an election to taxpayers to report increases in the value of discount obligations annually; Section 42(c), Internal Revenue Code of 1939, providing that income from short term government discount obligations should not be taken into account until disposition of the obligations; Section 125, Internal Revenue Code of 1939, providing an election to amortize premium; Section 113(b) (1) (H), Internal Revenue Code of 1939, providing a reduction in basis for amortized bond premium.

Appendix, interpretations by the Internal Revenue Service and its predecessors, until 1953, consistently treated the entire increment to a discount obligation as capital gain.²⁶ In fact, this position, directly contrary to that urged here, was taken as recently as one year prior to the Government's 1953 change of position in an informal ruling holding that the gain from the very type of commercial paper involved here was capital gain.²⁷ Published rulings to the same effect had been issued previously,²⁸ and the Government had successfully litigated this position.²⁹

The Government relies on cases holding that the debtor corporation can deduct discount over the life of the bonds. (Government's Br. p. 5). There are indeed cases which speak of this deduction as "interest,"³⁰ but the weight of authority is clearly that the deduction is allowed as a loss³¹—a capital item. In fact, the very case cited by

²⁶ The Revenue Service in fact acquiesced in *Caulkins* from 1944 to 1955, Acq. 1944 Cum. Bull. 5, non-acq. 1955-1 Cum. Bull. 7, albeit with reservations from 1953. See Rev. Rul. 119, 1953-2 Cum. Bull. 95.

²⁷ 5 CCH 1952, Stand. Fed. Tax Rep. par. 6161. This ruling uses the typical style of numerous cross-references so that its meaning is not clear without reference to § 211 (a) (1) (B), Internal Revenue Code of 1939 (dealing with capital gains of aliens) and to the request for the ruling published at 5 CCH 1952, Stand. Fed. Tax Rep. par. 6284.

²⁸ O. 1024, 2 Cum. Bull. 189 (1920); O. D. 475, 2 Cum. Bull. 211 (1920); I. T. 1398, 1-2 Cum. Bull. 149 (1922).

²⁹ *Corn Exchange Bank v. Commissioner*, 6 B. T. A. 159 (1927). The lack of litigation during the period between this case and the Treasury's change of position further emphasizes the point.

³⁰ e.g., *Western Maryland Ry. Co. v. Commissioner*, 33 F. 2d 695 (4th Cir. 1929).

³¹ 2 Mertens *Law of Federal Income Taxation*, § 12.109, ch. 12, p. 345 states: "Bond discount is founded upon the concept of compensation for a prospective loss"; Molloy, *The Ambiguous Tax Nature of the Various Costs of Borrowing Capital*, 11 Tax Law Review 373, 399-400 (1956), concludes that the weight of authority is that the deduction is allowed as a loss.

the Government for the proposition that the deduction is allowed as interest proceeds primarily on the contrary theory that the deduction is allowed as a loss.³² This Court stated in that case:

It is a loss to the taxpayer, definite as to its date and amount, and represents a part of the cost of the borrowed capital during each year of the life of the bond issue. 293 U. S., at 287.

Thus, under the law as it existed in 1944, the Sixth Circuit in *Caulkins* did not need to rely on the extensive materials available because it was generally agreed at that time that discount was a capital item.³³ For instance, the Government attorney in the *Caulkins* case conceded in the Tax Court proceedings that, in the absence of a special statutory exception, the increment on United States Savings Bonds would be capital gain. 1 T. C. 656, 662 (1943). In this setting, only a few years after a subcommittee of Congress had recommended that no change be made in the law taxing discount as capital gain,³⁴ no extensive authority was necessary for the Sixth Circuit to reach the correct result. Courts which later rejected *Caulkins*, moreover, relied primarily on cases such as *United States v. Snow*, 223 Fed. 2d 103 (9th Cir., 1955) cert. denied 350 U. S. 831, and the Sixth Circuit's own decision in *Fisher v. Commissioner*, 209 Fed. 2d 513 (6th Cir., 1954) cert.

³² *Helvering v. Union Pacific Co.*, 293 U. S. 282. Actually the Court was concerned throughout with commissions on the sale of bonds, but the governing principles are the same as those applicable to discount.

³³ Text writers were unanimously in accord. See 4 Mertens *Law of Federal Income Taxation*, § 23.162 n. 31; Newlove, *Intermediate Accounting* 205 (1939 ed.); Paton, *Advanced Accounting* 196 (1941); *Accountants' Handbook* 339 (2d ed. 1939); Lawrence, *Bond Discount Treatment Under the 1942 Revenue Act*, 21 *Taxes* 651 (1943).

³⁴ See note 24 *supra*.

denied 347 U. S. 1014, which stated the well-established principle that the sale of a right to ordinary income constitutes an assignment of income and results in ordinary income. Reliance only on this principle is, however, inevitably wide of the mark, for such reliance assumes the very point at issue, i.e., whether, prior to 1954, the increment in value of an admittedly capital asset (e.g., a bond or note), due to its purchase at a discount (for bargain price), was properly characterizable as an item of ordinary income rather than capital gain. Yet an examination of the pre-1954, and therefore governing, law is precisely what the cases contrary to *Caulkins*, all decided after Section 1232 had been enacted, neglected to undertake:

The authorities outlined above, which only the Sixth Circuit has passed on, all bear directly upon the question of the nature of the pre-1954 law on the narrow issue presented by this case. And the *Caulkins* decision, which is all that was passed on by the courts reaching a different result, did not itself, for the reasons indicated above, contain a consideration of those materials. Thus, in the last analysis, the Government's case for the grant of a writ of certiorari must stand or fall solely on the basis of an academic conflict in result, itself based on authority which failed to examine the directly relevant materials. The Government offers no defensible ground to justify granting the writ; it cannot and will not cite any judicial authority prior to 1953 to the effect that corporation bond discount is ordinary income; nor can it even cite any instance prior to 1953 where the administrative position was that such discount gain should be taxed as if it were interest.

Perhaps, were the narrow issue presented by this case of more than historical interest, this Court's intervention to resolve even such a conflict might be justified. A similar conclusion with regard to the petitions for the writ in the

cases now before the Court seems untenable, however, in light of the diminishing importance of the issue, and the fact that only one Circuit has passed upon the relevant legislative and judicial authority.

CONCLUSION.

For the reasons stated, respondent respectfully submits that the writ should be denied.³⁵

THEODORE R. COLBORN,
Counsel for Respondent.

THEODORE M. GARVER,
JONES, DAY, COCKLEY & REAVIS,
Of Counsel.

³⁵ Since there is technically no conflict in the treatment of an accrual taxpayer, if certiorari is granted in only one case, it should be granted here where the conflict is, rather than only in *Dixon v. United States*. See Government's Br. pp. 6-7.

APPENDIX.

MEMORANDUM OF THE DISTRICT COURT ON TAX
TREATMENT OF ORIGINAL ISSUE DISCOUNT.

(Filed March 11, 1963.)

KALBFLEISCH, J.

This is a suit to recover income and excess profits taxes for the years 1952, 1953 and 1954. The taxpayer is the Midland-Ross Corporation, successor in interest to the Industrial Rayon Corporation. During the period in question, for the purpose of temporarily investing funds not then currently required for its operation, the taxpayer purchased thirteen notes, the face amounts of which varied from \$500,000 to \$2,000,000. These notes bore no interest, but rather were purchased at a discount by the taxpayer from the maker. Each of the notes was a time instrument.

Before maturity each note was sold to a financial institution at a price which was in excess of the price which had been paid to the maker but below the face amount.

The price paid by the taxpayer to the maker of each note was calculated by subtracting from the face amount a figure determined by multiplying the face amount by an agreed percentage, dividing the product by 360, and multiplying the result by the number of days from the date of such payment to the maturity of the note. The agreed percentage was determined on the basis of the consideration of several factors, including (1) the prevailing interest rates for notes of such duration made by borrowers with credit standings of the obligor, (2) the availability of such notes to prospective purchasers, and (3) the maker's need for cash funds. All of the notes were capital assets in the hands of the taxpayer and were sold by it in bona fide sales. In negotiating the sale price of the notes, the following factors were considered: (1) the face

amounts of the obligations, (2) the credit rating of the obligor, (3) the period of time between the sale and the maturity of the notes, (4) the prevailing interest rates, and (5) the amount of cash funds available to the purchaser.

In this three-year period the taxpayer realized a total appreciation of more than \$280,000 on these notes. It contended that this appreciation was a capital gain, while the Internal Revenue Service contended that it was regular income. The taxpayer paid taxes at the regular income rate, and is here seeking a refund.

The relevant sections of the Internal Revenue Code are: Section 117(a) (1) (2) and (4) and Section 111(a) of the 1939 Code, and their counterparts in the Code of 1954.

Section 117(a) (1) of the 1939 Code defines a capital asset as:

"* * * property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *

(D) an obligation of the United States or of any of its possessions, or of a state or territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Subsections (2) and (4) of Section 117(a) provide that a capital gain is a gain from the sale of a capital asset, and Section 111(a) provides that the gain from the disposition of property is the "excess of the amount realized therefrom over the adjusted basis * * *."

Plaintiff stresses the fact that the language of the statute, especially of Section 117(a) (1) defining a capital

asset, is broad and sweeping. It contends that because these notes were capital assets the gain realized thereon was a capital gain. It contends, further, that in view of Section 117(a) (1) (D), which specifically excludes certain types of discount paper from the category of capital assets, and in view of the failure to exclude such paper as these notes, the Congress clearly indicated its intention that the gain achieved on the sale of such notes constitutes capital gain under the maxim of *expressio unius est exclusio alterius*.

The taxpayer's contention is a familiar enough general rule of statutory construction. However, various courts have read certain exceptions into this statute. They have held that, while it might appear that a literal construction of the statutory language would convert all but the specifically excluded gains into capital gains, the provisions must be construed in the light of their general purpose and the surrounding law. After so doing, these courts have read further exceptions into the statute, which have resulted in the exclusion from capital gains treatment of certain increments which a literal interpretation might indicate were capital gains. See, for example, *Jaglom v. Commissioner*, 303 F. 2d 847 (2nd Cir., 1962); *United States v. Harrison*, 304 F. 2d 835 (5th Cir., 1962). In view of the fact that these statutory sections have not been interpreted to include all of the transactions which the sweeping scope of their language might indicate were within their purview, the Court is constrained to hold that this argument is not dispositive of the case.

The Government contends that the realized increment was in fact interest paid for the use of money, and was therefore regular income to the taxpayer. It contends that this is but another instance for application of the well recognized rule that when a taxpayer combines the sale

of a right to receive ordinary income with the sale of a capital asset the ordinary income is not converted into a capital gain by its sale in combination with the capital asset. *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir., 1954), cert. den. 347 U. S. 1014; *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir., 1959); *Rosen v. United States*, 288 F. 2d 658 (3rd Cir., 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Cir., 1962); and *United States v. Langston*, 308 F. 2d 729 (5th Cir., 1962).

The taxpayer does not dispute the general validity of this proposition. Its principal contention, however, is that the rule is inapplicable on these facts because the increment, for purposes of taxation, at least, was not interest. It fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income under the rule of *Fisher v. Commissioner* and the other cases cited, *supra*. However, it contends that a different result is achieved when, instead of the notes bearing interest at a fixed rate, they were originally sold at a discount. The taxpayer urges that there has been a continuous history of legislative, administrative and judicial interpretation since 1920 which has consistently held that original issue discount in the hands of a cash basis taxpayer is not income, and that the appreciation resulting therefrom is not taxed as regular income but, rather, as a capital gain.

If it is true that historically the law has not considered such original issue discount as interest, but has removed it from the broad category of regular income and placed it within the specific classification of capital gain, then the increment in this case was not income and the general rule upon which the Government relies is inapplicable.

The Court, therefore, must proceed to examine the treatment which such discount has traditionally received.

Commissioner v. Caulkins, 144 F. 2d 482 (6th Cir., 1944) is the primary cornerstone upon which the taxpayer rests its contention that the increment here involved was not, for taxation purposes at least, compensation for the use of its money. In that case the taxpayer had purchased an accumulative installment certificate under the terms of which he was to make periodic payments to the seller, who, at the end of ten years, would pay to the taxpayer the sum of \$20,000. This \$20,000 was approximately \$4,900 more than the total amount of the payments made to the seller. The Commissioner contended that this \$4,900 was compensation for the use of the taxpayer's money, and was thus really interest. He held that this interest was regular income, although the taxpayer contended it was a capital gain.

The certificate involved in the *Caulkins* case was in registered form and the decision was based upon an interpretation of Section 117(f) of the Internal Revenue Code of 1939. Section 117(f) provided that amounts received by the holder of registered securities upon their retirement should be considered as amounts received in exchange therefor. The Court held that, although the \$4,900, at least in many respects, was similar to interest, it was an amount which was received in exchange for the sale of a capital asset and was therefore a capital gain.

To understand the *Caulkins* decision it is necessary to understand the history of Section 117(f). Before the enactment of that section it had been held that retirement of a bond was not such a sale or exchange as would qualify the amount received upon the retirement for capital gains treatment. See *Fairbanks v. United States*, 306 U. S. 436 (1939). Section 117(f) was enacted to avoid

this holding. It provided that amounts received upon the retirement of certain evidences of indebtedness which had interest coupons attached, or which were in registered form, should be considered as amounts received in exchange therefor. This provision enabled the amounts received upon the retirement of such bonds to qualify as capital gains. The taxpayer contends that this provision was enacted to accord the same tax treatment to such bonds upon their retirement as always had been accorded them on a sale before retirement. And, according to *Mertens Law of Federal Income Tax*, Volume 38, [sic] [Vol. 3B] page 368, M 82 [sic] [n. 82]:

"The purpose underlying the enactment of Section 117(f) of the 1939 Code was to accord to the retirement of obligations similar treatment as was then, and is now, accorded to their sale or exchange."

In view of the purpose of Section 117(f), it appears that before the passage of that section amounts received upon the sale of such evidences of indebtedness did qualify for capital gains treatment. If a sale before maturity of such obligations did not permit increments to be accorded capital gains treatment, it is unlikely that the Congress would have deliberately enacted a provision according them such favorable treatment upon retirement.

From the combination of this legislative history with the *Caulkins* decision it is possible to draw the following analogy: Section 117(f), under the *Caulkins* holding, provided that all amounts received in exchange for the retirement of a qualifying capital asset were capital gains. Because Section 117(f) was meant to be declaratory of the pre-existing law on sales before retirement, it follows that all amounts received on the pre-retirement sale of such debt obligations were likewise capital gains. The

validity of this analogy must be tested by a further inquiry into legislative, administrative and judicial history. However, before proceeding with that history it is necessary to examine the Government's position as to what the *Caulkins* case really held.

The Government contends that *Caulkins* was based solely upon an interpretation of Section 117(f). It says that the crucial fact in *Caulkins* was not that the debt obligations were discount obligations but that a retirement rather than a sale was involved. It has thus attempted to convince the Court that the *Caulkins* decision does not control this case, because in the present instance the notes were sold before maturity, rather than retired. It is true that the opinion in the *Caulkins* case primarily discusses the retirement factor; however, the Court is not convinced that increments on debt obligations which qualify under Section 117(f) would be accorded capital gains treatment if the obligations were retired, but would be taxed at regular income rates if they were sold before maturity. Even the Tax Court, which adopted that position in *Paine v. Commissioner*, 23 T.C. 391 (1954), Rev. 236 F. 2d 398 (8th Cir., 1956), and *Stanton v. Commissioner*, 34 T.C. 1 (1960), has now abandoned such a distinction. *Gibbons v. Commissioner*, 37 T.C. No. 57. The purpose of Section 117(f) surely was not to accord a more favorable tax treatment to income realized upon retirement of debt obligations than it would receive if they were sold before maturity. The quotation from *Mertens, supra*, also clearly indicates that such was not the case. Therefore, this Court is constrained to hold that the crucial fact in the *Caulkins* case was that the evidences of indebtedness were discount obligations.

The combination of the *Caulkins* case with Section 117(f) thus indicates that appreciation realized on evi-

dences of indebtedness, issued at an original discount and sold before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication.

The earliest administrative decision upon this matter which has been furnished to the Court is Office Decision 1024 published in Vol. 2, Cum. Bul. 189 (1920), holding that original issue discount on bonds was not interest and, therefore, was not subject to special withholding provisions when the bonds were in the hands of foreign corporations. It is true, as the Government contends, that this opinion was not concerned with whether an appreciation resulting from such discount was a capital gain or regular income. It was concerned, however, with whether such gain was in fact interest. The opinion carefully examined the various factors involved and came to the conclusion that original issue discount, while in some ways like interest, differed from interest in other respects and was in fact not interest.

The writers appear to have been agreed that in the period following 1920 a taxpayer could not accrue bond discount, but had to report all of it in the year in which it was received. No part of the discount was allowed to be treated as income prorated over the life of the bond. See *Accountant's Handbook*, 2d Ed., p. 339 (1932); Newlowe, *Intermediate Accounting*, p. 205 (1939); and 4 Mertens *Law of Federal Income Taxation*, Section 23.162, p. 298. However, this well established rule does not meet the real issue in question, which is whether the income, in the year in which it was reported, was treated as a capital gain or as regular income. There is, however, one case from this period which again reiterates the fact that discount is not interest. That case is *Corn Exchange Bank v. Commis-*

sioner, U. S. Board of Tax Appeals, 6 B. T. A. 158 (1927). Taxpayer had sought to amortize bond discount and premium. The Board of Tax Appeals refused to allow such amortization. In doing so, it said, at page 161:

"The discount on the bond purchased below par is unlike interest, which is a fixed charge and accrues periodically. The right to receive this discount, or difference between the cost of the bond and its par, cannot be determined in advance as the bond may be sold for more or less than its cost, or, perhaps, as in the case of many bonds, it may be redeemed prior to its maturity at an amount different from its principal or face amount of the bond. This discount is not earned or accrued in annual installments and can not be income to the holder of the bond, either as additional interest or as a separate item of income."

The Government contends that the *Corn Exchange Bank* opinion was dealing only with regular discount as distinguished from original issue discount. It fully agrees that discount which is the result of such factors as an obligor's default in interest payments does not give rise to ordinary income. However, an examination of both the fact and the opinion in the *Corn Exchange Bank* case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transaction involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved.

This case indicates that during the 1920's the Department of Internal Revenue, which prevailed in the *Corn Exchange Bank* decision, had contended that discount was not interest. And if discount was not interest, income resulting from discount could not have been taxable at regular rates on the premise that it was interest.

In 1940 the Internal Revenue Service held that income realized from the redemption of state discount bonds was interest, and, accordingly, was non-taxable. G. C. M. 21890, 1940-1, Cum. Bul. 85. It said the courts had considered the nature of discount and found it to be like deferred interest. Such discount was, in effect, payment for the use of the money lent. The value of this ruling is questionable, however, because it necessarily involved statutory and constitutional limitations upon the federal taxation of state bonds. And while the ruling held that such discount was like interest, it carefully avoided holding that it was interest. Thus, at least until 1940, and possibly thereafter, the Internal Revenue Service held that discount was not interest. The legislative treatment of bond discount should be viewed against this administrative background.

In 1929 the Congress authorized the Treasury Department to issue non-interest-bearing discount obligations. The bill authorizing these notes, as passed by the House and as approved by the Senate Finance Committee, contained a provision that, as to profits attributable to the discount, "any gain from the sale or other disposition thereof shall be exempt from all taxation." Congressional Record, Senate, June 4, 1929, p. 2319. This provision for tax exemption met with considerable opposition upon the floor of the Senate, *because the Senators believed such profits were capital gains*, and feared that such a provision would open the way for the future exemption of all capital gains from taxation. Several members of the Senate engaged in a lengthy debate about the relationship between original issue discount and interest, and the tax consequences that flowed therefrom. That debate indicates that at least some members of the Senate believed that original issue discount was in fact a substitute for

interest; but those who purported to be familiar with the subject pointed out that, under the then current practice of the Bureau of Internal Revenue, income attributable to original issue discount was treated as a capital gain and not as regular income. See page 2331, Congressional Record, *supra*. The question was finally resolved by the insertion of a provision in the bill that amounts received as the result of original issue discount on these notes would be called interest, thus bringing them within the already existing interest exemption. Likewise, a similar provision was added as an amendment to the Second Liberty Bond Act of 1917, Title 31 U. S. C. A., Section 757c (d). Thus, the legislative history indicates that appreciation resulting from this discount was statutorily transformed into interest to avoid its taxation as a capital gain.

These facts further substantiate the taxpayer's contention that during the period of the 1920's and early 1930's original issue discount was not considered interest, but rather gave rise to a capital gain. Furthermore, the Congress was aware of this construction and acquiesced therein by failing to statutorily change the rule until 1954. See Section 1232a(2) (A), Internal Revenue Code of 1954. This section now provides that, upon the sale or exchange of evidences of indebtedness issued by a corporation or a government, amounts of appreciation attributable to original issue discount will not be considered as gains resulting from the sale or exchange of a capital asset. In other words, in 1954, and governing evidences of indebtedness issued after the ones which are now before this Court, the Congress stated that appreciation resulting from original issue discount would henceforth be considered as regular income and not as capital gain.

The House report accompanying this section stated that under existing law such gains were taxed as capital

gains if the bond was held to retirement, and that this section was enacted to change the rule insofar as appreciation resulting from original issue discounts was concerned. 3 U. S. Code Congressional and Administrative News, 1954, p. 4110. The report of the Senate Finance Committee is less helpful. It merely stated that "There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount * * *." 3 U. S. Code Congressional and Administrative News, 1954, p. 4745. In support of its statement that there was some confusion as to the current status of the law, the Senate report compared *Commissioner v. Caulkins* to I. T. 3486, 1941-2 Cum. Bul., p. 76. However, the Internal Revenue holding, upon which the Senate Committee relied, dealt only with a specific statutory provision which provided that such gains realized on the sale of Treasury bills should be interest. That provision had been enacted to make such gains non-taxable by bringing them within the exemption which interest enjoyed. Thus, the Senate Report does not cite any evidence of uncertainty insofar as the generally applicable principles are concerned.

At various times the Congress has enacted special provisions regarding the treatment of discount. For instance, the Internal Revenue Code of 1939, Sections 201(e) and 207(e), provided that stock and mutual life insurance companies must accrue discount.

And in 1938 the House Ways and Means Committee discussed the relationship between discount and interest. That Committee report stated:

"It is important also to emphasize that there is no clear separation, in practice, between capital gains and ordinary income; * * * A bond purchased at a pre-

mium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain." Hearings on H. R. 9682, Subcommittee of Committee on Ways and Means, 75th Congress, Third Session, p. 39. (Emphasis added.)

Here again is evidence of Congressional knowledge that appreciation due to bond discount was a capital gain. The Subcommittee recommended that no change be made in this rule.

Again, in Section 42(b) of the 1939 Internal Revenue Code, the Congress gave taxpayers an election to treat as current income the periodic increases in redemption value of non-interest-bearing obligations issued at a discount when such obligations were redeemable for fixed amounts which increased at stated intervals.

Thus the evidence indicates that the Congress clearly believed that appreciation resulting from original issue discount was a capital gain. With this knowledge Congress adopted various pieces of specific legislation providing for special treatment of discount in certain specified situations. However, Congress took no action to change the general law. These facts indicate a Congressional intention, until 1954, that capital gains treatment continue to be accorded to gains resulting from bond discount. And there was no indication of any thought that different treatment should be given to gains resulting from original issue discount than was accorded those resulting from other types of discount.

Both parties have cited various explanations and public policies underlying the special treatment which the Congress has accorded to capital gains. As the Government has indicated, there are several reasons for this special treatment. However, even the Government cannot deny that one important reason is to avoid taxing, at

unusually high rates, income which has in fact been earned over a number of years but which is realized only in the year of sale. In other words, the accumulation of income actually accrued over a period of years, but realized only in the year of sale, which is inherent in the profitable sale of most capital assets, would, under our system of highly progressive income taxation, result in a taxation of such income at far higher rates than would have been the case if the income had been reportable in each of the years in which it accrued but was not realized. The capital gains provisions place a limit upon the extent to which such gains can be taxed. In view of this purpose, it certainly appears that the long-term appreciation, resulting from original issue discount of bonds and other evidences of indebtedness, can be appropriately fitted within that category of appreciation which is accorded the special capital gains treatment.

In several instances the Tax Court has had occasion to consider the proper method of taxing gains resulting from original issue discount. It must be remembered that in the *Corn Exchange Bank* case, *supra*, the Board of Tax Appeals held that discount was not interest. The next occasion on which the Court was faced with the problem was in *Caulkins v. Commissioner*, 1 T. C. 656 (1943), where it decided that original issue discount gave rise to a capital gain and not to regular income. It was this opinion which was affirmed by the Sixth Circuit in *Commissioner v. Caulkins*, *supra*.

In 1954, on a complex factual situation, it held that discount was really interest and therefore gave rise to regular income when the securities were sold before maturity. *Paine v. Commissioner*, 23 T. C. 391 (1954). That holding was reversed by the Eighth Circuit in *Paine v. Commissioner*, 236 F. 2d 398 (1956). While it cannot be

said that the Eighth Circuit held that discount resulted in a capital gain, that Court did hold that the appreciation involved in the *Paine* case was not interest. The language of the Court further indicates, however, that it did not think that discount created gains which were taxable as regular income.

Another case before the Court was *Commissioner v. Morgan*, 30 T. C. 881 (1958), involving accumulative investment certificates identical to those in the *Caulkins* case. The Tax Court held that the appreciation on these certificates was a capital gain. The Commissioner appealed that determination to the Ninth Circuit, which reversed the Tax Court. *Commissioner v. Morgan*, 272 F. 2d 936 (1959). The Court of Appeals considered the Sixth Circuit's *Caulkins* decision and refused to follow it. The Court held that Section 117(f) was designed only to allow capital gains treatment to be accorded to "true" capital gains. The Court refused to give the language of Section 117(f) the all-encompassing scope that it had been accorded by the Sixth Circuit.

The Tax Court reaffirmed its holding that such gains were capital gains in *Goodstein v. Commissioner*, 30 T. C. 1178 (1958). And it was again faced with another of the *Caulkins*-type accumulative investment certificates in *Kormendy v. Commissioner*, 18 T. C. M. 353 (1959). This case was decided after *Morgan* but before the reversal of *Morgan* by the Ninth Circuit. Again, the Tax Court affirmed its *Morgan* and *Caulkins* holdings.

Finally, in 1960, after the reversal of the *Morgan* decision by the Court of Appeals, the Tax Court again had a similar problem in *Stanton v. Commissioner*, 34 T. C. 1 (1960). In that case the taxpayer had purchased short-term Government notes and commercial paper at a dis-

count. This paper he sold before maturity but after holding for more than six months. The excess of the amount realized over the cost was reported as a long-term capital gain. The Tax Court held that the appreciation was regular income because the notes were sold before maturity. In support of this decision the Court cited its *Paine* opinion, which it said had been reversed on other grounds.

The most recent case that it has considered was *Gibbons v. Commissioner*, 37 T. C. No. 57. In *Gibbons* the Tax Court held that discount was *always* interest, and thus regular income, no matter whether it was realized upon a sale or exchange before retirement, or upon the retirement of a debt obligation. Thus, in *Gibbons*, the Tax Court completely rejected the *Caulkins* decision, and abandoned the distinction that it had made in *Paine* and *Stanton* between gains realized on a sale and gains realized on a retirement.

The problem of original issue discount has been considered recently by a number of constitutional courts. Most of the decisions which were cited to this Court have but again reaffirmed the validity of the general principle for which the Government contends. When the evidences of indebtedness in question were interest-bearing obligations the applicability of this proposition cannot be questioned. Cases which have dealt with the rule in such situations are: *Fisher v. Commissioner*, 209 F. 2d 513 (6th Circuit, 1954), cert. den. 347 U. S. 1014; *United States v. Langston*, 308 F. 2d 729 (5th Circuit, 1962); *Arnfeld v. United States*, 163 F. Supp. 865 (Court of Claims, 1958), cert. den. 359 U. S. 943; and *Jaglom v. Commissioner*, 303 F. 2d 847 (2nd Circuit, 1962); cf. *Commissioner v. Phillips*, 275 F. 2d 33 (9th Circuit, 1960). Thus, there are only five cases which actually have dealt with the treatment to be accorded to gains resulting from original

issue discount. Those cases are: *Commissioner v. Caulkins*, 144 F. 2d 492 (6th Circuit, 1944); *Commissioner v. Morgan*, 272 F. 2d 936 (9th Circuit, 1959); *Rosen v. United States*, 288 F. 2d 658 (3rd Circuit, 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Circuit, 1962); and *Pattiz v. United States*, Court of Claims No. 219-61 (1963). The *Morgan* and *Rosen* decisions were based upon the same fact situation that was presented to the Sixth Circuit in *Caulkins*. The results in the Third and Ninth Circuits were obtained by a specific rejection of the *Caulkins* decision. In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. Likewise, the *Harrison* and *Pattiz* decisions were based upon a specific rejection of *Caulkins* and on an adoption of the *Morgan* and *Rosen* opinions, and neither case considered the historical treatment of original issue discount. Therefore, while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the *Caulkins* case, which is controlling in this Circuit.

The following factors support the taxpayer's contention: (1) the opinions of the Department of Internal Revenue and the Board of Tax Appeals, during the 1920's and early 1930's, that discount was not interest; (2) Congressional belief, expressed both in 1929 upon authorization of Treasury bills and later in the Second Liberty Bond Act, that original issue discount resulted in a capital

gain, and consequent Congressional action to avoid that result; (3) the report of the Subcommittee of the Ways and Means Committee of the House of Representatives, in 1938, that discount gave rise to a capital gain; (4) Congressional enactment of various specific pieces of legislation providing that appreciation resulting from discount would be treated as other than a capital gain; (5) the failure of the Congress to take any action to change the treatment of bond discount except in regard to highly specialized factual situations; (6) the passage of Section 117(f), as interpreted by the *Caulkins* decision, indicating that all amounts received upon retirement, and attributable to original issue discount, were capital gains; (7) the numerous early opinions of the Tax Court that original issue discount resulted in a capital gains; and (8) the fact that none of the cases which have rejected *Caulkins* have considered the historical treatment of bond discount. Against these factors, and in support of the Government's contention, it is possible to infer, from several administrative rulings dealing with specific statutory situations, that bond discount was really interest and was taxable as regular income. The 1929 Senate debate and the 1938 House hearings refute any possible implication from other Congressional enactments that original issue discount resulted in regular income. The factors supporting the taxpayer's contention are clearly of controlling weight.

It may well be that, in financial circles at least, original issue discount is considered to be a form of interest. If this is the case, it is certainly understandable why the various courts of appeal, which have considered this question on an almost *de novo* basis, have held that original issue discount resulted in regular income to the taxpayer. It is likewise true that there has been a trend—commencing with certain legislative enactments, proceeding

through some administrative interpretations, and culminating with the Congressional enactment of 1954—toward classifying appreciation resulting from original issue discount as interest. This trend began with certain very specific factual situations and expanded to include nearly all governmental and corporate evidences of indebtedness. However, careful study of this developing trend confirms the Court's belief that it has effectuated a change in the law. The facts in this case are not within any of the specific factual situations for which this change has been made and, therefore, the Court is constrained to hold that, as to the notes here in question, the appreciation for taxation purposes was not interest but, rather, an appreciation on capital, and was therefore taxable as a capital gain.

Should it be required, this memorandum will be adopted as findings of fact and conclusions of law under Section 52(a), Federal Rules of Civil Procedure.

GIRARD E. KALBFLEISCH,
United States District Judge.